

Legal Forms of Business Structure Summary

Overview

The legal structure of a business plays a crucial role in determining how accounting, taxes, and liability are managed. The choice of business form directly affects how income is reported, the way taxes are paid, and the level of protection owners have from individual lawsuits.

Five Most Popular Legal Forms of Business Structures

#	Business Structure	Description	Liability	Taxation	Management & Ownership
1	Sole Proprietorship	A business owned and operated by one individual. It's the simplest and most common form of business.	Unlimited personal liability — the owner is personally responsible for all debts and obligations.	Pass-through taxation — business income is reported on the owner's personal tax return (Form 1040, Schedule C).	The owner makes all decisions and controls operations.
2	Partnership	Two or more people share ownership and responsibilities.	Unlimited liability (for general partners); in a limited partnership, limited partners have liability only up to their investment.	Pass-through taxation — profits and losses flow to partners' personal returns (Form 1065 & Schedule K-1).	Managed according to a partnership agreement; decisions are typically shared.
3	Limited Liability Company (LLC)	A flexible hybrid that combines elements of partnerships and corporations.	Limited liability — owners (members) are protected from personal liability for business debts.	Typically, pass-through taxation, but may elect corporate taxation.	Managed by members or appointed managers; fewer formalities than corporations.
4	Corporation (C Corp)	A legal entity separate from its owners (shareholders).	Limited liability — shareholders' personal assets are protected.	Double taxation — the corporation pays taxes on profits, and shareholders pay taxes on dividends.	Managed by a board of directors and officers; ownership via shares of stock.

#	Business Structure	Description	Liability	Taxation	Management & Ownership
5	S Corporation (S Corp)	A special type of corporation with pass-through taxation (for small to medium businesses).	Limited liability	Pass-through taxation — profits taxed only once at the shareholder level.	Similar to C Corp but with limits on shareholders (max 100, must be U.S. citizens or residents).

Impact of Business Structure

The legal form selected for a business has significant implications. It determines how the business reports its income, the manner in which taxes are paid, and the extent of protection from personal liability in the event of lawsuits. These considerations are crucial for both new and existing business owners when determining the most suitable structure for their operations.

Below is Table 1-1 from our textbook (p. 11), which compares the legal forms of Business Structures.

Table 1-1: Comparing Legal Forms of Business Structure

<i>Characteristic</i>	<i>Sole Proprietorship</i>	<i>Partnership</i>	<i>S Corporation</i>	<i>C Corporation</i>	<i>LLC</i>
Ease of formation and maintenance	Simple	Moderate	Complex	Complex	Moderate
Limited Liability	No	General Partner: No Limited Partner: Yes	Yes	Yes	Yes
Pass-through profits and losses	Yes	Yes	Yes	No ⁽¹⁾	Yes

⁽¹⁾ The C corporation pays taxes as a separate legal entity. If shareholders receive dividends, they also pay taxes at the individual level.

 **Key Differences Among the Five Structures**

ASPECT	SOLE PROPRIETORSHIP	PARTNERSHIP	LLC	C CORPORATION	S CORPORATION
OWNERSHIP	One person	Two or more partners	One or more members	Shareholders	Up to 100 shareholders
LEGAL ENTITY	Not separate from the owner	Not separate (except LPs)	Separate	Separate	Separate
LIABILITY PROTECTION	None	Shared / limited in LP	Yes	Yes	Yes
TAXATION	Personal (Schedule C)	Personal (K-1)	Pass-through or corporate	Corporate + shareholder (double)	Pass-through
FORMATION REQUIREMENTS	Simple, minimal paperwork	Partnership agreement	State filing (Articles of Organization)	Incorporation (Articles of Incorporation)	Incorporation + IRS S-election
CONTINUITY	Ends with the owner's death	Ends if partner leaves (unless agreement states otherwise)	Continues with members	Perpetual	Perpetual
BEST FOR	Freelancers, local services, self-employed	Professional firms, family businesses	Small to medium firms wanting flexibility & liability protection	Larger or growth-oriented firms seeking investors	Small corporations seeking liability protection & pass-through tax benefits

Choosing the Right Structure — Key Considerations

1. Liability Risk:

- If your business has low risk (e.g., tutoring, consulting), a sole proprietorship or partnership may suffice.
- If risk or debt exposure is higher (e.g., property management, retail), an LLC or corporation provides more protection.

2. Tax Goals:

- Sole proprietors and partnerships avoid double taxation.
- Corporations pay more tax but can offer deductions and fringe benefits.

3. Growth & Investment:

- Corporations can issue stocks and attract investors.
- LLCs offer flexibility for smaller teams or family businesses.

4. Compliance & Formalities:

- Corporations require board meetings, bylaws, and annual filings.
- LLCs and sole proprietorships are simpler to manage.

5. Longevity:

- Sole proprietorships end with the owner.
- Corporations and LLCs continue beyond the founders' involvement.

Summary

The best structure depends on the owner's goals, risk level, tax preferences, and desire for control. For many small businesses, the **LLC** offers a balance between **simplicity, flexibility, and liability protection** — while a **sole proprietorship** remains ideal for very small or low-risk operations. Consult your accountant for professional and individual considerations.